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US Earnings Preview: A lower, but more affordable, orbit

The sky is not falling but Q4 earnings growth on the S&P 500 is expected to slow from the stellar pace of around 25%, achieved in the first three quarters of 2018.

On Monday, Citigroup will unofficially launch the US earnings season, with JP Morgan and Wells Fargo set to follow suit on Tuesday. Dimming prospects for future global growth, coupled with unabated trade tensions, have driven analysts to cut their expectations for earnings-per-share (EPS) growth from 16.7% at the start of the fourth quarter to 11.4% at the beginning of 2019, according to data compiled by FactSet. Nonetheless, if 11.4% is the actual growth rate for the quarter, it will mark the fifth straight quarter of double-digit earnings growth for the index.

The stakes are quite high after a painful December and investors need to see some positive numbers – especially given that earnings are a key driver of stock market performance. Our equity specialists note that with a lower hurdle in terms of expectations, there is some scope for surprises on the upside. It is also hoped that guidance for 2019 delivered on the accompanying earnings calls will be more in tune with economic reality, in contrast to the bearish sentiment on markets.

The ominous mood was further magnified by Apple's profit warning at the onset of the year in which it cut its revenue outlook by $9 billion, citing falling iPhone sales in China on the latest three models. This gave the bears something more to chew on, adding to concerns about an overall slowdown in the Chinese economy as well as trade war fears. After the announcement, the estimated EPS growth rate for the fourth quarter was revised down by 1% for the aggregated US equity market measured via the S&P500. However, upon closer analysis, our equity analysts see some signs that this in fact could be an idiosyncratic issue caused by price elasticity problems affecting the price milestone (above $1,000) on the latest generation of iPhones.

Amidst the negative sentiment which could easily curb enthusiasm for equities, we must not lose focus of the fundamental picture which is still quite robust and implies that the US is in a 'slowdown' rather than a 'contraction' . The economy is still expanding, just not at the breakneck speed enjoyed on the back of Trump's massive fiscal stimulus program, namely tax cuts. Consensus forecasts show US GDP growth at 2.6% for 2019 and we rarely see margin contraction when this figure is over 2%. In addition, consumer sentiment is robust, and the latest jobs report was solid with 312k jobs added while previous months were significantly upward revised. At the same time, the Federal Reserve has pledged to be flexible on monetary policy and said it is in no rush to raise interest rates. The prospect of rising rates is a source of concern for equity investors since they induce higher bond yields, eroding the relative attractiveness of stocks and the present value of future cash-flows. The US 10- year Treasury yield has in fact come down recently from around 3.2% to 2.7%.

With these factors, amongst others considered, we maintain a positive stance on US equities ahead of earnings season – particularly on late cyclicals, quality, low beta and large cap stocks.

Over the longer term, a lot will depend on how US/ China trade negotiations play out. Due to the interconnected nature of the world economy, if the two don't find common ground, it is very unlikely that any economy will come out unscathed and this could put a dent in corporate profitability.

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